Blue Ribbon Commission on Public Employees Retirement Systems

Managing Retiree Medical (and other OPEB) liabilities

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Discussion Topics

- Need for Change
- Creating sustainable benefits
- Current benefits provided
- How entities manage their benefit promise
- Issues Facing the Commonwealth
- The General Approach for assessing and managing the liabilities
  - OPEB benefits
  - Underlying health care plan claim cost management
  - Financing strategies

Indicators for change

- Up until recently, many systems funded their retiree medical program on a pay-as-you-go "paygo" basis
  - This was an effective way to manage a pay package without incurring immediate costs
  - This is also a benefit appreciated by the employees
- These costs were relatively low, since the boomers had not yet started to retire

Indicators for change- Contribution Requirements

	KTRS University/ Non University	KERS Non Hazardous	KERS Hazardous	CERS Non Hazardous	CERS Hazardous	SPRS
ARC- Pension	14.82%/ 17.78% (Est.)	15.55%	10.20%	6.98%	15.01%	28.95%
ARC Insurance	11.31%	32.82%	36.91%	20.51%	39.52%	91.05%
ARC Total	26.13%/ 29.09%	48.37%	47.11%	27.49%	54.53%	120.00%

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Indicators for change - Accrued Liabilities

	KTRS	KERS Non Hazardous	KERS Hazardous	CERS Non Hazardous	CERS Hazardous	SPRS
UAL-Pension (source-June 30, 2006 valuations)	$1.2 Billion	$3.6 Billion	$.08 Billion	$1.0 Billion	$.5 Billion	$.2 Billion
UAL-Insurance	$4.2 Billion	$7.2 Billion	$.4 Billion	$3.8 Billion	$1.5 Billion	$.5 Billion
UAL-Total	$5.4 Billion	$10.8 Billion	$.5 Billion	$4.8 Billion	$2.0 Billion	$.7 Billion

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Indicators for change –The Total Accrued Liability

- The total unfunded accrued liability for all plans is approximately $24.2 billion dollars
- The UAL for pension totals $6.6 Billion
- The UAL for Insurance totals $17.6 Billion

Why is there a need for change?

- GASB is the indicator that shows the "true" actuarial cost of the plan.
- GASB sheds light on the "pay now or pay later" issue of actuarial funding
  - If the contribution rates for full actuarial funding are not sustainable, then the benefits are also not sustainable
    - Similar to an "implicit tier" in the plan

Sustainability of Benefits

- One of the key objectives for any governmental entity is to ensure the sustainability of the benefits
- Governmental entities do not want to "run out of money" and leave workers with less than promised
- Sustainability can be an economic measurement
  - GASB is a guide to determining sustainability
  - The valuation tells us the ARC (actuarially required contribution)
    - If that ARC cannot be met, then sustainability must be reexamined

Defining Sustainability

- Upon seeing the first OPEB valuation, an entity may then be able to focus on their own unique definition of economic sustainability
  - It may be a long term (i.e. 20 years) percent of payroll cost
  - It may be a long term dollar cost
  - Sustainability can be determined from available resources, and perhaps from new revenue streams
  - Once sustainability is defined, benefits can be designed in light of the contractual rights, to meet the sustainability requirements
  - Without sustainability, there will be an implicit tier of benefits

What Are The Current Retiree Medical Benefits?

- KTRS
  - Generally, anyone receiving a retirement benefit from KTRS is eligible for medical insurance benefits.
  - Retirees under 65 are offered coverage through the State Group Health Plan (SGHP)
  - A retiree age 65 or older is offered coverage through the KTRS self-insured Medicare Eligible Health Plan (MEHP)
  - Primarily funded by retirees, actives (.75% of their pay), employers and through actuarial funding by the Commonwealth.

What Are The Current Retiree Medical Benefits?

- KERS (includes County and State Police Systems)
  - Participation prior to July 1, 2003
    - The Retirement System pays a portion of the medical premiums for retirees.
    - For hazardous duty retirees, their dependents and beneficiaries, the insurance fund will pay 0%, 25%, 50%, 75% or 100% of the premiums depending on retiree eligibility.
  - Participation on or after July 1, 2003
    - The Retirement System pays $10 per month per year of service toward medical premiums for non-hazardous retirees.
    - For hazardous retirees, the System pays $15 per month per year of service, and $10 per month per year of service for surviving spouses of hazardous employers.
    - Line of duty benefits are calculated "as if" the member had at least 20 years of hazardous service.

How are other governmental entities resolving the management their benefit promise?

- There are three key areas where liabilities can be reduced;
  - The ***finance and funding strategy*** for the OPEB obligation (Workgroup I)
  - ***Retiree medical Plan design*** (determining the optimal level of benefits to be provided) (Workgroup II)
  - Health Care benefits (***managing the underlying claim costs*** while optimizing the benefits provided to actives and your pre-65 retirees) (Workgroup III)

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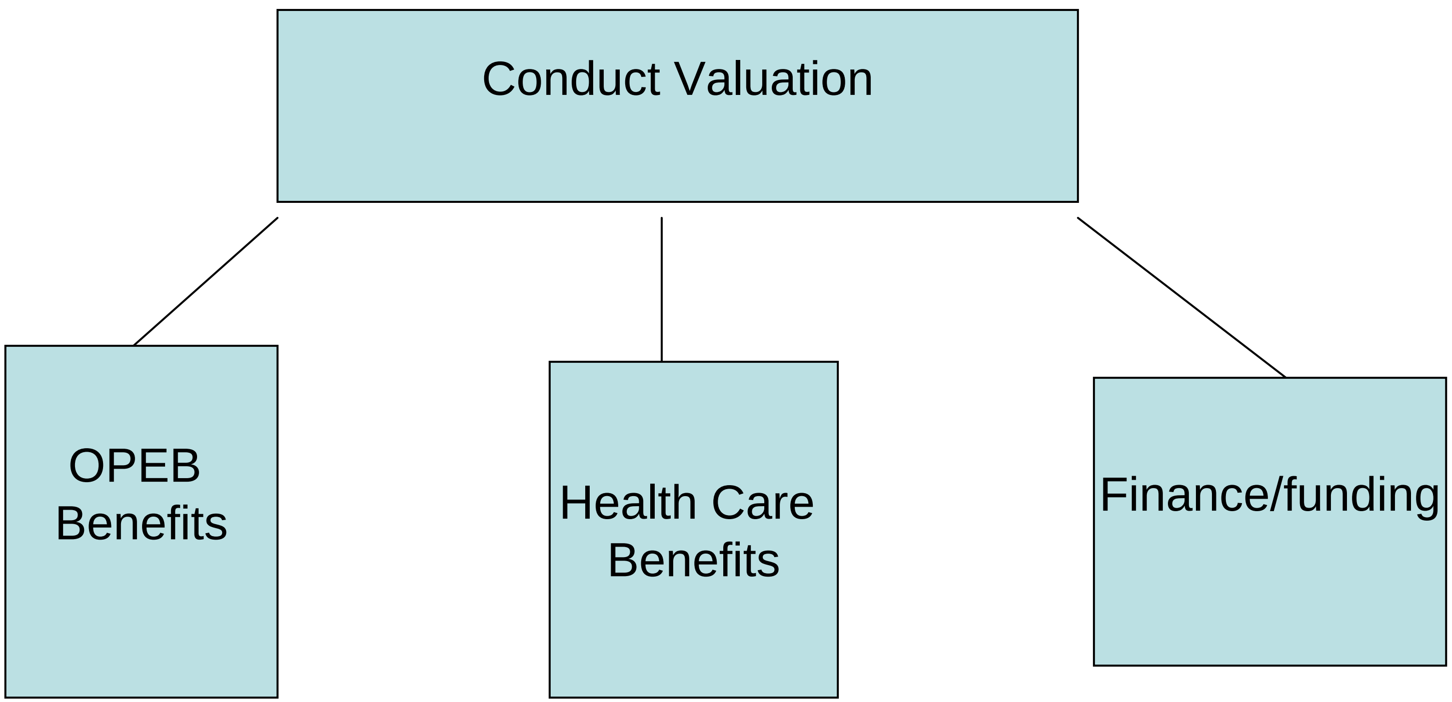
Look At Critical Issues Facing Both Member And The Commonwealth

- Access to health care coverage when retired
- Affordability to the retired member
- Sustainability of the Plan by the Commonwealth
- Equity among the population segments
  (equity not necessarily meaning equal)

General Approach to Managing OPEB Liabilities

Kentucky has already completed the valuation



Trust Finance and Funding Workgroup I

- Entities also are exploring (once the benefit structure is fully established) the extent to which to prefund the benefits
- It only makes sense to look at this once you know the benefits and eligible population
  - Recent legal counsel findings have mostly resolved this issue
- Liabilities can be cut by prefunding and using investment return to fund some of these benefits
- Entities also look at OPEB bonds- very similar to the presentation made in August 2007 on Pension Obligation Bonds.

Retiree Medical Plan Design Workgroup II – Post employment benefits

- Responses are as unique as the number of plans that exist.
- The OPEB plan has already created a second tier of benefits- thereby serving to reduce the OPEB liability for those members.
- Legal counsel indicated benefits are to be preserved for current employees

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Claim Cost Management Workgroup III – Healthcare Benefits

- This solution runs at the same time as all others.
- Involves looking at the underlying health plan to see how to minimize claim costs while optimizing benefits to the members.
- Legal counsel indicated all benefits must be at least equal in value to the 1994 benefit promise.

Developing The Long-term Financing Strategy

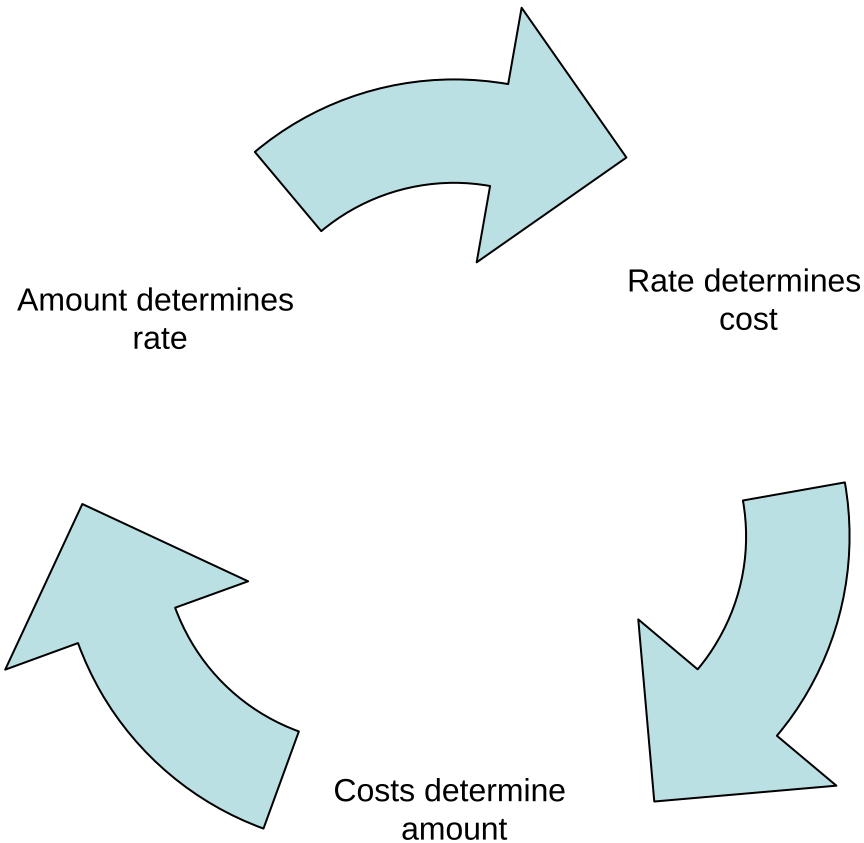
- What exemplifies an appropriate strategy?
  - Creating value for the employees while
    - Value includes sustainable benefits
    - Without sustainability, an implicit tier is created
  - Minimizing expenses
    - Being careful to minimize expenses to the Commonwealth

General Financial Challenges faced by the Commonwealth

- Increased encroachment on the general fund
  - Balanced budget requirement also means budgetary displacement of other programs
  - Have already taken steps to reduce long term liabilities
- GASB 45 compliance
- Bond rating agency concerns
  - The goal is to preserve ratings to keep costs of borrowing down
- Public relations and political fallout
  - HR concerns
  - Contractual rights

Developing The Long-term Financing Strategy

- Once the ultimate benefits are known
  - The next decision is whether to prefund (and to what level)
  - This is a "circular" study because
    - The extent of prefunding determines discount rate
    - Discount rate determines costs
    - Costs determine the level of prefunding



Developing The Long-term Financing Strategy

- General rule if you are in a circle
  - Measure the endpoints
  - Determine costs if the obligation is fully funded to the ARC;
  - Then determine the costs if the obligation is funded at its minimal "pay-as-you-go" amount
  - Also, it is very useful to look at a long term projection of cash flow for both of these scenarios

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Developing The Long-term Financing Strategy

- Look at the cash flow projection of the annual costs over the next 10-20 years
  - Compare to the general fund
  - There should be a “cross over” point where prefunding costs become lower than the pay-as-you-go- that is the point where both the population is booming and the investment returns in the trust are starting to pay for some of the benefits.

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Determining The Value Of Prefunding

- It is not always obvious that prefunding is the optimal decision
  - Prefunding may not be affordable
  - Prefunding does require the funds to be placed into an irrevocable trust- meaning they can never be used for other budgetary needs
  - However, prefunding does create a value by decreasing the ARC (and therefore decreasing the growth in the Net OPEB Obligation)

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Developing The Long-term Financing Strategy

- KERS Non-Hazardous and SPRS are using lower discount rates in the Insurance valuation of 4.5%, instead of a "full funding" rate of 7.75%
- The difference in the Actuarial Required Contribution when using these two different rates is:
  - KERS Non Hazardous 32.82% v. 18.68%
  - SPRS 91.05% v. 43.05%

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Developing The Long-term Financing Strategy

- Under current conditions – KERS Non Hazardous
  - Present Value of all Insurance Benefits $10.4 Billion
- Estimate of PVB of all Insurance Benefits if liabilities are reduced 60% - $ 6.2 Billion
- However, the $6.2 Billion must be contributed to an irrevocable trust at the "ARC" level for each year.
- Funding the ARC will raise expenditures
  - Review in light of balanced budget requirements

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Is Prefunding The Optimal Strategy?

- First, look for statutory or bargaining requirements on prefunding (then you do not have to proceed with determining an optimal strategy)
- Look at the growth of the Net OPEB Obligation (NOO) under both the prefunding and the pay-as-you-go scenarios
  - The NOO is the cumulative difference between the ARC and the actual contribution
  - Measure impact on cost of capital and on budget

Is Prefunding The Optimal Strategy?

- Look at cash flow with and without prefunding
  - Take a long period of time, e.g. 30 years
  - Determine a net present value between the choices
- This is answering the question of whether there is a long term value to the Commonwealth for prefunding.

Outcome Examples

- We see that implicit subsidy-only plans tend not to prefund
- Plans where the costs are very small relative to the general fund may not prefund
- Government entities are raising concerns about prefunding relative to
  - What if we go to national health care?
  - What if we issue an OPEB bond and want the ability to prepay?
- Entities that prefund are often those that have been doing so for years
- A few have actually looked at accelerating their prefunding
- To be in the California group trust, prefunding is a must

Responses To Managing OPEB Liabilities Through Benefit Changes

- First, entities seek to determine what benefits are inviolable.
- The Commonwealth has received a report from their outside Counsel on this matter
- To the extent all benefits (past and future) for current employees are protected, then solutions will be found in the financing and claim cost side of liability management.

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Overriding Factors In The Decision

- First, this is an issue of optimizing benefits while minimizing costs
  - Reducing OPEB expenses too quickly can create “friction” with members
  - Yet reducing expenses too slowly can actually raise the overall costs to the entity
- Thus, approaches generally have to look at these issues concurrently

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What are the next steps?

- You now know contractual rights, so you know which groups can be affected.
- From this, you can develop a "matrix" of benefit changes for both OPEB and the health plan that
  - Meet any known sustainability objective
  - Meet the benefit objective
- Next, the strategies developed from each workgroup can be valued for their effectiveness in achieving the financial and sustainability goals of the Commonwealth.
- A phasing strategy, including multi-year strategies, may need to be developed

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